No. 17037

United States
COURT OF APPEALS
for the Ninth Circuit

BUILDING SYNDICATE CO.,
Appellant,

v.

UNITED STATES OF AMERICA,
Appellee.

APPELLANT'S BRIEF

Appeal from the United States District Court for the District of Oregon.

HONORABLE JOHN F. KILKENNY, Judge.

THOMAS B. STOEL,
GEORGE H. FRASER,
DAVID G. HAYHURST,
HART, ROCKWOOD, DAVIES, BIGGS & STRAYER,
1410 Yeon Building,
Portland 4, Oregon,
Attorneys for Appellant.

STEVENS-NESS LAW PUB. CO., PORTLAND, ORE. 11-60

SUBJECT INDEX

SUBJECT INDEX (Cont.)

TABLE OF CASES

STATUTES INVOLVED

OTHER AUTHORITIES

No. 17037

United States
COURT OF APPEALS
for the Ninth Circuit

BUILDING SYNDICATE CO.,
Appellant,

v.

UNITED STATES OF AMERICA,
Appellee.

APPELLANT'S BRIEF

Appeal from the United States District Court for the District of Oregon.

HONORABLE JOHN F. KILKENNY, Judge.

JURISDICTIONAL STATEMENT

This action originated in the United States District Court for the District of Oregon. The jurisdiction of that court was based on Title 28 U.S.C. Section 1346, Judiciary and Judicial Procedure. The action was brought by appellant, plaintiff below, against the United States to recover federal income tax for the year 1953 erroneously collected under the internal revenue laws. Appellant is an Oregon corporation and filed its federal income tax

return for the calendar year 1953 with the District Director of Internal Revenue, Portland, Oregon.

This court has jurisdiction of the appeal under Title 28 U.S.C. Section 1291, Judiciary and Judicial Procedure.

STATEMENT OF THE CASE

The complaint in the District Court sought recovery from appellee, defendant below, of $23,669.38 representing the portion of appellant's claim for refund of federal income tax for 1953 which had been rejected by the District Director of Internal Revenue.

Statement of the Facts

This case was tried below upon the facts stipulated in the pretrial order (R. 3-23), the oral testimony of three witnesses, and the exhibits introduced at the trial. The pretrial order lists the exhibits introduced by each of the parties.

A summary statement of the facts is as follows: In the spring of 1927 the real property then known as the "Northwestern Bank Building" property was owned by the Northwestern National Bank of Portland (Oregon), hereinafter called "Northwestern" (R. 4). Prior to June 21, 1927, Northwestern placed this property in the hands of George N. Black, a real estate broker, for purposes of sale (R. 4). Also prior to June 21, 1927, Mr. Black entered into negotiations with George W. York & Company, Inc., Cleveland, Ohio, hereinafter called "York," relative to financing the sale of the property (R. 4). These

negotiations culminated in a commitment by York dated June 21, 1927, to purchase an issue of land trust certificates representing the equitable ownership in the Northwestern Bank Building property at a price of $1,250,000 net (R. 4, Ex. 1). Subsequent to June 21, 1927, York associated with it the Union Trust Company of Cleveland, hereinafter called "Union," for the purpose of carrying out its commitment (R. 5).

Mr. Black had interested Harry C. Kendall, then Vice President of Lumbermens Trust Company, in the possibilities of the Northwestern Bank Building property, and Mr. Kendall, in turn, had interested a group of Portland investors who on August 1, 1927, organized Building Syndicate, an Oregon corporation, hereinafter called "Syndicate," and subscribed for $300,000 of its stock (R. 68, 70, 71, 73). Mr. Black, who had an option to buy the property for $2,200,000, assigned this option to Syndicate (Ex. 19, 20, R. 74).

Mr. Kendall and his coinvestors in Syndicate recognized that with capital of $300,000 they could not hope to acquire ownership of the property through first and second mortgage financing (R. 107). They believed that they would have an attractive investment if Syndicate could obtain a long-term leasehold on the property plus an option to purchase (R. 74) and that this could be done by having a trustee for land trust certificate holders acquire the property and give a long-term leasehold to Syndicate (R. 104, 107). Syndicate would raise additional moneys to acquire the leasehold by issuing through Lumbermens Trust Company first mortgage leasehold bonds (R. 107, 108, Ex. 8).

The acquisition of the property in the name of Security Savings & Trust Company (Portland, Oregon), hereinafter called "Security," which was the cotrustee of Union, was closed through an escrow on September 30, 1927 (R. 5, 6). In the closing Northwestern conveyed the property to Security; Security and Union as cotrustees executed an agreement and declaration of trust between themselves and "The Holders of Land Trust Certificates of Equitable Ownership in the Northwestern Building Site Located in Portland, Oregon, Leased to Building Syndicate (an Oregon corporation)" (R. 5, 6, Exs. 4, 6). Security leased to Syndicate the property involved for a period of 99 years, and Syndicate entered into an indenture with Lumbermens Trust Company to secure an issue of $750,000 first leasehold bonds (R. 5, 6, Exs. 7, 8). Payment to the seller for the property and delivery of the above-described documents were effected in a single escrow transaction on September 30, 1927 (R. 6).

The sources of the funds for payment of $2,202,-133.07 to the seller by the trustee were as follows (R. 6):

From trustee for Land Trust Certificate holders (proceeds of sale of 1,350 Land Trust Certificates of Equitable Ownership	$1,250,000.00
From Building Syndicate (proceeds of sale of leasehold bonds and of stock)	952,133.07
	$2,202,133.07

In 1928 the name of the property was changed to American Bank Building (R. 7). In 1932 the leasehold

bonds of Syndicate went into default and a bondholders' committee was organized (R. 7). In 1943, the leasehold bonds being still in default, the trustee for the bondholders acquired Syndicate's assets on December 31 of that year (R. 7). On November 9, 1944, a new corporation known as Building Syndicate Co., the appellant herein, hereinafter called "New Company," was organized (R. 7). The assets of Syndicate, including its lease on the bank property, were transferred to New Company on December 31, 1944, the acquisition of the assets by the trustee and their transfer to New Company being a tax-free reorganization under the Internal Revenue Code (R. 7).

On their federal income tax returns from 1927 through 1944 Syndicate and New Company mistakenly claimed depreciation deductions on the bank building each year on the basis of the remaining life of the building (assumed in 1927 to be 36 years) rather than amortizing the cost of the 99-year leasehold which they held (R. 9). On its tax return for the year 1945, New Company claimed depreciation from January 1, 1945, on the new allocated cost of the building based on an assumed life of 32 years from that date (R. 9, 10). Under these methods Syndicate and New Company had claimed deductions through October 31, 1945, aggregating $549,215.08 (R. 10). Computed on the basis of amortization over a 99-year life, the aggregate amortization of New Company's leasehold as of October 31, 1945, was $172,272.65 (R. 10). The excess of the deductions taken over leasehold amortization was $376,942.43; of this excess $274,784.49 did not result in tax benefit (R. 10).

The lease held by Syndicate and New Company contained an option to purchase the fee interest of the property from the lessor upon written notice (R. 8). New Company exercised this option to purchase on October 31, 1945. After exercising the option, New Company set up on its books as the basis of the land and building the unamortized balance of the leasehold estate per books at December 31, 1944, plus the amount paid on exercise of the option, and this total was allocated between land and building (R. 8, 9). Under this method the total cost of the property was shown on New Company's books in the amount of $1,842,-023.14 and this was allocated as follows (R. 8, 9):

Land	$ 817,027.29
Building, less Dunham System, elevators, and alterations	1,000,779.96
Dunham System, elevators, and alterations	19,591.33
Leasehold, Parcel B (unamortized)	4,624.56
	$1,842,023.14

On its tax return for the year 1945 and thereafter, New Company claimed depreciation on the basis of the amount so allocated to the building. The Commissioner of Internal Revenue disallowed so much of the depreciation claimed on New Company's 1953 return as was based on the portion of the 1945 option payment allocated to building. New Company paid the resulting deficiency and interest ($23,669.38) and following denial of its claim for refund brought this suit.

Question Involved

The question involved is that set forth as Issue 1 of the pretrial order (R. 11). It may be stated as follows:

Should the amount paid by New Company in 1945 to exercise its option to purchase the American Bank Building property be taken into account in computing New Company's basis for depreciation of the property?

Appellant is not raising in this appeal Issue 2 of the pretrial order (R. 11) with respect to which appellant contended in the court below that amounts claimed by it and Syndicate as deductions on the American Bank Building in excess of amortization on its leasehold cost (to the extent that such excess resulted in no tax benefit) should not be applied to reduce appellant's basis for the property (Plf.'s Contention 5, Pretrial Order, R. 12).

SPECIFICATIONS OF ERROR

1. The District Court erred in stating Findings of Fact Nos. 2, 19, 20, and 21 as findings of fact, since they are actually conclusions of law (R. 38, 39).

2. The District Court erred in stating in the second sentence of Finding of Fact No. 12 (R. 37) that—

> "The annual accounting reports, prepared by independent accountants, consistently showed that Building Syndicate regarded itself as the owner of the bank building,"

and in failing to find that the report of the independent accountants for the year 1938 (Ex. 52-N) was changed

at the request of the trustee to reflect ownership by Syndicate of a leasehold and that this method of presentation was continued in reports for later years (Exs. 52-O, P).

3. The District Court erred in concluding that Syndicate was the owner of the building for income tax purposes during the years 1927 through 1943 and that it properly computed depreciation on the total purchase price of the building (Finding of Fact No. 20, R. 39).

4. The District Court erred in concluding that the retirement of the land trust certificates was equivalent to refinancing a loan and had no effect on the basis of the property (Finding of Fact No. 19, R. 38) and that New Company's basis for depreciation is the same as that of its predecessor (Finding of Fact No. 21, R. 39).

5. The District Court erred in concluding that the lease and declaration of trust show that all parties regarded Syndicate as the owner of the building (Conclusion of Law No. 3, R. 39), since those documents conclusively establish that its interest was a leasehold with an option to purchase.

6. The District Court erred in making Finding of Fact No. 21 (R. 39) that the basis for depreciation in New Company was the same as it was in Syndicate.

7. The District Court erred in concluding that Syndicate was the owner of the building during the years in question (Conclusion of Law No. 4, R. 39), since its only interest in the building was a leasehold with an option to purchase.

8. The District Court erred in concluding that this case is controlled by the decision in *Helvering v. F. & R. Lazarus & Company,* 308 U.S. 252, 60 S. Ct. 209 (1939) (Opinion, R. 30, 31).

9. The District Court erred in concluding that appellant failed in its burden of proof (Conclusion of Law No. 2, R. 39).

10. The District Court erred in failing to hold as a matter of law that neither New Company nor Syndicate made any investment in the building prior to exercise of the option to purchase in 1945.

11. The District Court erred in failing to hold that the first capital investment in the building by either New Company or Syndicate was made when New Company exercised its option to purchase in 1945.

12. The District Court erred in failing to hold that after exercising its option to purchase in 1945 New Company properly added the option price to the net leasehold estate (computed after reduction by the amount of depreciation previously claimed) and allocated this sum between land and building and that the sum so allocated to the building became New Company's depreciation base for the building.

SUMMARY OF ARGUMENT

1. The District Court erred in failing to apply to this case the property law rule adopted in all of the land trust income tax cases.

2. Both property law and income tax cases apply the doctrine that a deed will not be treated as a mortgage unless both parties intended it as security.

3. The record affirmatively shows that Union intended that the land trust transaction involving the Northwestern Bank Building should create a lessor-lessee relationship and not a mortgagee-mortgagor relationship.

4. Instead of destroying appellant's position as the District Court thought, the Supreme Court decision in *Helvering v. F. & R. Lazarus & Company,* 308 U.S. 252, 60 S. Ct. 209 (1939), states the basic law which appellant believes is controlling in this case and which requires a holding for appellant.

5. The double tax benefit theory set forth in *The Akron Dry Goods Company,* 18 T.C. 1143 (1952), *aff'd per curiam,* 218 F. 2d 290 (6th Cir. 1954), has no application to this case since a decision for appellant cannot result in a double tax benefit.

6. The agreement determining the tax liability of Syndicate for 1927 has no effect for subsequent years.

ARGUMENT

I

Introduction

Appellant recognizes that under Rule 52(a) of the Rules of Civil Procedure for the United States District Court, the trial court's findings of fact are to control unless they are clearly erroneous. Except for the findings described in the Specifications of Error (Findings Nos. 2, 19, 20, and 21) as being actually conclusions of law and Finding No. 12 described in the Specifications of Error as inconsistent with certain of the exhibits, appellant does not challenge the findings.

The District Court's opinion states the issue in the case to be—

> "Whether Syndicate properly claimed and was allowed an income tax deduction for depreciation on the American Bank Building (formerly Northwestern Bank Building) during the years 1927 through 1943 computed on the basis of the total purchase price paid to the original vendors of the property."

It goes on to say that—

> "The answer to the question is solved by determining whether Syndicate, during such years, should be treated as the owner, for tax purposes, of the building in question."

In its conclusional Finding of Fact No. 20, the lower court then sets forth its answer, namely, that—

> "During the years 1927 through 1943, Building Syndicate, for income tax purposes, was the owner of the property in question."

Appellant accepts the District Court's statement of the issue as quoted above. But as a matter of law the court has fallen into error, first, in its view that the answer is to be found by determining whether Syndicate should be treated as the owner of the building *for tax purposes,* and, second, in its conclusion in Finding No. 20 that Syndicate was the owner *for income tax purposes.*

II

An analysis of the District Court's opinion reveals the reasoning which led it into error as a matter of law.

The test applied in all of the land trust cases involving the deduction by a lessee of depreciation on a building on the leased premises is whether the lessee has a capital investment in the building. This question is answered by applying property law concepts to determine whether the lessee had the rights of an owner-mortgagor or held a leasehold estate. See *Helvering v. F. & R. Lazarus & Company,* 308 U.S. 252, 60 S. Ct. 209 (1939); *City National Bank Building Company v. Helvering,* 98 F.2d 216 (D.C. Cir. 1938); *Commissioner v. H. F. Neighbors Realty Company,* 81 F.2d 173 (6th Cir. 1936); *The Akron Dry Goods Company,* 18 T.C. 1143 (1952), *aff'd per curiam,* 218 F.2d 290 (6th Cir. 1954).

The District Court in this case applied a different test of its own devising. It asserted that it was not necessary for the government to contend that the land trust transaction here involved created a mortgage with Syndicate as the owner-mortgagor and Union as the

mortgagee (R. 31). Its opinion indicates that it believed the established rules of property law to be inapplicable and that under some independent "tax purpose" concept Syndicate could be held to be the "owner for tax purposes" and so entitled to deduct depreciation. It repeatedly stated that Syndicate should be treated as the owner "for tax purposes" (R. 27) or "for all tax purposes" (R. 30) or "for income tax purposes" (R. 39).

Having adopted this new concept as its test of ownership, the court gave two principal reasons for finding its test satisfied: (1) because Syndicate's treatment of the transaction on its tax returns and accounting records showed that it regarded itself as the owner, it should therefore be treated as the owner *for tax purposes* (R. 27, 28) and (2) if Syndicate were not treated as the owner, a double tax benefit would be allowed (R. 32). While the court at some points in its opinion purported to consider the intent of the parties and states that "all parties . . . regarded Syndicate, not the trustees, as the real owner of the building" (R. 29), it nowhere analyzed the evidence *under property law tests for determining ownership.*

As to the first of the District Court's reasons listed above, appellant will show that whether a lessee is the owner of property so as to be entitled to take depreciation deductions depends on whether, under property law concepts, it, in fact, has a capital investment in the property and not on its unilateral representations in its tax returns and reports. As to the second of the court's reasons, it is apparent that the court did not understand

that in the computation of its claimed basis for the property, appellant has reduced the original cost of the leasehold by the prior depreciation deductions erroneously taken. Thus, it is not claiming as a part of its basis for the building the basis recovered through prior depreciation deductions—even those taken without tax benefit.

III

A series of cases involving land trust transactions have settled the principles of law to be applied in this case.

Having traced the lower court's reasoning and analyzed what appellant believes to be the principal errors in its reasoning, we turn now to the rules of law which control this case. They can be summarily stated:

(1) It will be recalled that appellant agrees with the lower court that the issue in the case is whether Syndicate properly claimed depreciation on the American Bank Building from 1927 to 1943. It is clear that the answer to this question turns on whether Syndicate had a capital investment in the building. The rule is well established that the statutory allowance for depreciation is available only to taxpayers (including lessees) who can show that they have a depreciating capital investment in the property. *Weiss v. Wiener,* 279 U.S. 333, 49 S. Ct. 337 (1929); *Dab v. Commissioner,* 255 F.2d 788 (2d Cir. 1958); *Atlantic Coast Line Railroad Company v. Commissioner,* 81 F.2d 309 (4th Cir. 1936).

(2) A lessee in a land trust transaction will be found to have a capital investment in the building only if,

under property law tests, it clearly appears that the lessee is the equitable owner of the property as a mortgagor rather than the holder of a leasehold estate. *Helvering v. F. & R. Lazarus & Company,* 308 U.S. 252, 60 S. Ct. 209 (1939); *City National Bank Building Company v. Helvering,* 98 F.2d 216 (D.C. Cir. 1938); *Commissioner v. H. F. Neighbors Realty Company,* 81 F.2d 173 (6th Cir. 1936); *The Akron Dry Goods Company,* 18 T.C. 1143 (1952), *aff'd per curiam,* 218 F.2d 290 (6th Cir. 1954).

(3) In all of the land trust cases, the basic documents (the deed to the trustee, the trust agreement for the benefit of the land trust certificate holders, and the lease to the lessee) purport to create a lessor-lessee relationship. However, under the equitable doctrine of property law that a deed absolute on its face will be held a mortgage if both parties so intended, a lessee may in a proper case be held to occupy the position of an owner-mortgagor. *Helvering v. F. & R. Lazarus & Company,* 308 U.S. 252, 60 S. Ct. 209 (1939); *City National Bank Building Company v. Helvering,* 98 F.2d 216 (D.C. Cir. 1938); *Commissioner v. H. F. Neighbors Realty Company,* 81 F.2d 173 (6th Cir. 1936); *The Akron Dry Goods Company,* 18 T.C. 1143 (1952), *aff'd per curiam,* 218 F.2d 290 (6th Cir. 1954).

IV

There is no conflict in the land trust tax cases as to the applicable law. The divergent results flow from significant factual distinctions.

In the application of the rules summarized above, the courts in some instances have held that the arrangement by which the trustee for land trust certificate holders took legal title to property and granted a leasehold estate to the lessee made the lessee the equitable owner of the entire property with the trustee holding only a security interest. In these cases the lessee as owner of a mortgagor's equity of redemption was found entitled to recover through depreciation deductions the entire capital investment in a building on the leased premises. See *Helvering v. F. & R. Lazarus & Company,* 308 U.S. 252, 60 S. Ct. 209 (1939); *Commissioner v. H. F. Neighbors Realty Company,* 81 F.2d 173 (6th Cir. 1936).

On the other hand, where the land trust-lease arrangement was found to give the lessee only a leasehold estate and no equitable ownership as a mortgagor, then it had no capital investment in the property entitling it to depreciation deductions. *City National Bank Building Company v. Helvering,* 98 F.2d 216 (D.C. Cir. 1938); *The Akron Dry Goods Company,* 18 T.C. 1143 (1952), *aff'd per curiam,* 218 F.2d 290 (6th Cir. 1954).

All of these cases recognize the doctrine of property law that "a court of equity will treat a deed, absolute in form, as a mortgage, when it is executed as security for a loan of money." *Helvering v. F. & R. Lazarus &*

Company, 308 U.S. 252, 255, 60 S. Ct. 209, 210 (1939), quoting from *Peugh v. Davis,* 96 U.S. 332, 336 (1877). In the application of that doctrine they also rely upon the principle that a deed will be construed as a mortgage only if both the parties so intended. That principle and its application to this case are discussed below.

(a) Both property law and income tax cases apply the rule that a deed will not be treated as a mortgage unless both parties intended it as security.

It is fundamental that before a deed absolute on its face will be declared a mortgage, it must be proved that the parties intended the deed only as security. The intention of the parties at the time of the transaction is determinative. *Colahan v. Smyth,* 159 Or. 569, 575, 81 P.2d 112, 115 (1938). Since the documents are presumed to create the relationship they purport to create, it is only when the evidence shows clearly that the parties intended a mortgagor-mortgagee relationship to exist that a court will find the presumption overcome. *Coyle v. Davis,* 116 U.S. 108, 112, 6 S. Ct. 314 (1885); *Rogers v. Burt,* 157 Ala. 91, 47 So. 226 (1908). And to be operative, the intent of the parties must be mutual. The unilateral intent of one party is ineffective. *Cousins v. Crawford,* 258 Ala. 590, 63 So. 2d 670, 677 (1953); *Saxton v. Campbell,* 210 Minn. 29, 297 N.W. 348, 349 (1941); *Glasgow v. Andrews,* 129 Cal. App. 2d 660, 277 P.2d 400 (Dist. Ct. App. 1954).

The two lines of income tax cases in the land trust field, described above, supra p. 16, both apply these

property law principles. However, on the basis of the fact situations involved in the *Lazarus* and *Neighbors* cases (including direct testimony by representatives of the lessee or by representatives of both the lessee and the trustee), the courts there held that the transactions were intended to be mortgages. On the other hand, on the basis of somewhat different facts in the *City National and Akron* cases and in the absence of such testimony by the parties, the court found that the lessees were intended to receive what the documents purported to give them, that is, a leasehold.

(b) The parties to the present transaction intended that the land trust arrangement should give Syndicate a leasehold and not equitable ownership as a mortgagor.

In the present case both Mr. Kendall, who participated in the original transaction on behalf of Syndicate, and Mr. Coney, who represented Union, testified that the transaction was intended to be exactly what the documents show it to have been, an absolute sale of the building by Northwestern Bank to the trustee with a lease-option to Syndicate. No loan was ever even considered. Nor was it ever considered that the trustee was taking title only as security (R. 77, 78, 104, 118, 119, 120).

The District Court dismisses this testimony on the grounds that it is inconsistent with Syndicate's minutes, tax returns, and accounting records and with what the District Court regards as a proper construction of the lease and declaration of trust. However, viewed in the

whole context of the transaction, there are logical explanations for the alleged inconsistencies.

Syndicate was formed by a group of Portland businessmen who believed that through the land trust device they could acquire an interest in the Northwestern Bank property with a minimum investment on their part. They knew that with $300,000 of equity money they could not hope to float first and second mortgages and acquire ownership of the property. But they realized that by joining with the land trust certificate holders who would take the fee, they could finance the acquisition of a long-term leasehold using that leasehold as the security for issuance of first mortgage leasehold bonds. Thus put in possession of the property under a lease containing an option to purchase, they could see the possibility that they might ultimately acquire the entire interest in the premises if their expectations as to the earning power of the building materialized (R. 74).

The Northwestern Bank transaction marked the first use of land trust certificates in Oregon so that it was an unfamiliar device to Oregon investors (R. 113). Since Syndicate became the lessee under a long-term net lease with a purchase option—entitled to all the income and assuming all the expenses of the building—it is not surprising that Syndicate's directors thought of their corporation in laymen's terms as the "owner." And in light of the unsettled state of the income tax law on the point, Syndicate's mistake in claiming depreciation deductions on its tax returns as the "owner" of the build-

ing is equally understandable. Syndicate acquired its leasehold in 1927. The question whether a long-term lessee under a land trust arrangement could claim depreciation was subject to considerable confusion as late as the Supreme Court decision in the *Lazarus* case in 1939. See also *The Minneapolis Security Building Corporation,* 38 B.T.A. 1220 (1938).

In any event, it is clear that Syndicate's records are not evidence of the intent of the trustee and cannot affect the lessor-lessee relationship which the trustee intended to create between the parties. None of the information contained in these records was communicated to the trustee at the time of the transaction; therefore it cannot be evidence of the intent of the trustee. At most, it relates only to a unilateral intent which can have no effect on the relationship of the parties as lessor and lessee.

The record is bare of any evidence to show that the intent of Union as trustee was to create a mortgage relationship with Syndicate. In fact, the record clearly negatives such an intent on the part of Union—an intent which is essential to a holding that Syndicate acquired equitable ownership as a mortgagor. In addition to the unequivocal testimony of Mr. Coney, the representative of the trustee, that no mortgage was intended, the record shows several actions of the trustee in which it consistently asserted the position of a lessor—not that of a mortgagee.

Thus when the lease went into default in the 1930's, Union asserted the right of a lessor to cancel on 60

days' notice with no right of redemption in the lessee. It did not threaten a mortgage foreclosure nor did Syndicate's officers believe they could assert a mortgagor's equity of redemption (R. 103, 106, 107).

It is also highly significant that when it came to the trustee's attention in 1938 that Syndicate's annual report by its independent auditor might be interpreted as showing that Syndicate had an ownership interest in the land and building, the trustee requested that the balance sheet presentation be changed (Ex. 52-N, pp. 5, 6). Syndicate acquiesced in the request and the revised balance sheet as of June 30, 1938, and subsequent reports show Syndicate as owning a leasehold estate (Exs. 16, 52-N, O, P). Indeed the revised balance sheet as of June 30, 1938, showing the changed method of presentation was incorporated in the printed letter of July 22, 1938, from Syndicate to the land trust certificate holders soliciting their consent to a lease modification (Ex. 16).

In short, in every instance where it had an opportunity to evidence its intent—by testimony, documents, and action — Union has uncompromisingly taken the position that the transaction was not a mortgage and that Syndicate had only a lessee's interest in the premises.

Also important as evidence of the intent of Syndicate and the trustee, and as a distinction between the two lines of income tax cases involving land trusts, is the fact that as a part of the original transaction Syndicate mortgaged its leasehold estate to secure a loan in

the face amount of $750,000. The leasehold mortgage is in evidence as Exhibit 8 (R. 15, 64). Bonds secured by this mortgage were sold to the public. For Syndicate and the trustee to have agreed that their relationship was not that provided by the terms of the lease would have been the grossest kind of fraud on these bondholders.

Appellant has found no case in which a transaction has been held to be a mortgage where, as here, the alleged mortgagor's leasehold interest in the property was used to secure a loan from third persons. The only case it has found involving a leasehold mortgage is *City National Bank Building Company v. Helvering,* 98 F.2d 216 (D.C. Cir. 1938), in which the contention that the transaction was a mortgage was rejected. It should be noted that the substance of the leasehold mortgage floated by Syndicate is emphasized by the fact that the leasehold bondholders actually foreclosed and became the owners of the leasehold (R. 7).

(c) The intention of the parties that Syndicate should have a leasehold estate is supported not only by testimony but by other significant facts in the transaction between the trustee and Syndicate.

There are two principal income tax cases holding a land trust arrangement to be a mortgage, *Helvering v. F. & R. Lazarus & Company,* 308 U.S. 252, 60 S. Ct. 209 (1939), and *Commissioner v. H. F. Neighbors Realty Company,* 81 F.2d 173 (6th Cir. 1936). We have pointed out that both of these cases are unlike the present case since both contained affirmative testimony by

one or both of the parties that a security arrangement was intended. There are other differences, the most important of which are listed below:

(1) In *Lazarus* and *Neighbors,* the taxpayers had owned the properties and buildings for some years. Syndicate had no prior interest in the property.

(2) In *Lazarus* and *Neighbors,* the taxpayers were seeking refinancing of existing mortgage indebtedness on the properties. Syndicate had no debt to refinance and neither applied for nor was offered a loan.

(3) In *Lazarus* and *Neighbors,* the property was conveyed to the trustee by the taxpayer. Here the property was sold to the trustee by a third party.

On the other hand, the similarity between the present case and the *City National* case is striking. With respect to each of the three points mentioned above, the *City National* facts parallel those in the present case and are unlike those in *Lazarus* and *Neighbors.*

In addition, the taxpayers in *Lazarus* and *Neighbors* were not given the right to mortgage their leaseholds. That right was given Syndicate and the lessee in the *City National* case and in both cases the leaseholds were mortgaged to secure a bond issue sold to the public.

Furthermore, it must be kept in mind that the question actually presented by the *Lazarus* and *Neighbors* cases was not whether the taxpayer made a capital investment in depreciable property as a part of the land trust certificate transaction. In those cases, as we have

seen, the taxpayer had an interest in depreciable property prior to the time of the transaction, since it was the original owner of the premises. The question in those cases was whether or not that investment had been recovered through a sale of the property to the trustee. In the instant case, the taxpayer had no interest in the property prior to the land trust certificate transaction. The issue in this case, therefore, is whether it made an original investment in depreciable property as part of the transaction. Since Syndicate admittedly had no obligation to repay the amount of the investment of the land trust certificate holders, the extent of its investment in the property is limited to the amount paid for the leasehold estate. The *Lazarus* and *Neighbors* cases are therefore not authority for the proposition that Syndicate acquired an interest in depreciable property in the 1927 transaction.

(d) The lease and declaration of trust on their face created a leasehold in Syndicate and are not evidence that the parties intended a mortgage transaction.

At one point in its opinion (R. 29) the District Court refers to "the action taken by the directors of all interested groups" as showing an intention to make Syndicate the owner of the building. So far as the directors of the trustee are concerned, the only evidence in the record of action by them is the recitals in the lease and declaration of trust that the directors authorized their execution. Similarly, the only action by the directors of Lumbermens Trust Company was to authorize execution of the mortgage indenture securing the lease-

hold bonds. Since the above-quoted language of the lower court's opinion is followed by a statement that the lease and declaration of trust by themselves show that all parties regarded Syndicate as the owner of the building (R. 29), it may be that the court thought that the formal recitals of director authorization in the instruments justified the assertion that the action of the directors of all parties showed an intention to make Syndicate the owner-mortgagor.

The District Court's attempt to find that the instruments on their face created in Syndicate an ownership interest rather than a leasehold does not stand up under analysis. The following points concerning the lease and trust agreement were noted by the court in its opinion (R. 29):

(1) The depreciation fund was under the control of Syndicate and the amount of the fund would be credited on the purchase price in the event of exercise of the option. The only significance of this provision is that it increased the likelihood that the option would be exercised since the fund would be forfeited to the trustee on termination of the lease. This is not evidence, however, that the parties regarded Syndicate as the owner from the beginning of the transaction. Many leases contain options to purchase at a specified price without having the effect of causing the lessee to be considered the owner either under property law concepts or for tax purposes. In this instance all that the Syndicate investors thought their company was receiving was a lease and the possibility "that we would ultimately be able to exer-

cise the option to acquire the property if the earnings panned out as well as indicated" (R. 74).

(2) The lease was for a period of 99 years, renewable forever. The law is well settled that the holder of a long-term lease, 99 years or more, will not for that reason be considered the owner of the property for income tax purposes. *Weiss v. Wiener,* 279 U.S. 333, 49 S. Ct. 337 (1929); *Dab v. Commissioner,* 255 F.2d 788 (2d Cir. 1958).

(3) The rent was fixed at 5½ per cent of the principal amount of the land trust certificates and remained so fixed irrespective of contingencies or change in values of property. This is true of many long-term leases in which the lessee assumes the risk that the rental value of the property will increase or decrease. A fixed rental is simply one of the terms which define the benefits and burdens attached to Syndicate's ownership of a long-term leasehold.

(4) The lease provided that if the property was appropriated to public use, the appropriation constituted an election by the lessee to purchase and, if the appropriation was only partial, there would be no reduction in the amount of the rent. Provisions of this general type are not unusual in a long-term lease. (See forms in McMichael, Leases, Percentage, Short and Long Term, Fourth Ed. (1947), p. 199.) In the case of *Dab v. Commissioner,* 255 F.2d 788 (2d Cir. 1958), a 99-year lease provided that if the property were condemned or the mortgage thereon foreclosed, 75 per cent of the proceeds of condemnation or foreclosure would be paid to the

lessee. The court held that this did not show a capital investment by the lessee in the building entitling him to depreciation.

(5) The lessee carried the insurance on the property and was to receive the benefits between the insurance proceeds and the cost of restoration in the event of casualty. Where a lease is made for a long term on a net lease basis, the lessee is required to keep the property insured and in such leases it is not uncommon to provide for payment to the lessee of excess insurance proceeds, McMichael, Leases, Percentage, Short and Long Term, Fourth Ed. (1947), p. 167. However, the mere existence of the right to excess insurance proceeds does not constitute an investment by the lessee in depreciable property any more than the existence of a right to condemnation or foreclosure proceeds entitled the lessee in the *Dab* case to claim depreciation. Of course, if Syndicate actually restored the premises at its own expense, then the amount so expended would represent a capital investment which it could recover through depreciation deductions.

Finally, substantially all of the factors listed above were present in the documents in the *Lazarus* and *City National* cases. Yet the courts in those cases accepted the fact that the documents themselves gave the trustee the fee and the taxpayer a leasehold. They recognized that to decide the question which the cases presented they were required to look to "extrinsic evidence behind a transfer absolute on its face to determine whether only a security transaction was contemplated by the parties."

Helvering v. F. & R. Lazarus & Company, 308 U.S. 252, 255, 60 S. Ct. 209, 211 (1939). And in *The Minneapolis Security Building Corporation,* 38 B.T.A. 1220 (1938), the Board held that the lessee under a land trust lease containing provisions of this type did not have an exhaustible interest in the building because "The exhausting property which it owns is the leasehold." 38 B.T.A. at 1221.

(e) Far from destroying appellant's position as the District Court thought, the Supreme Court decision in *Helvering v. F. & R. Lazarus & Company,* 308 U.S. 252, 60 S. Ct. 209 (1939), states the rule of law which appellant believes is controlling in this case.

The District Court in its opinion says that "the benefit of *City National* to plaintiff's position was destroyed by the decision of the Supreme Court in the *Lazarus* case" and that it considers "*Lazarus* to be the law in this case" (R. 31). These statements appear to result from the court's mistaken view that there is some special rule of ownership for "income tax purposes," for the court failed to recognize that the *Lazarus* case applies the same rule of property law as the *City National* case and only arrives at a different result because of factual distinctions which we have discussed at length earlier in this brief.

The factual distinctions between *City National* and *Lazarus* which we have pointed out and which were the express basis for the differing results reached by the Board of Tax Appeals in the two cases (see 34 B.T.A. 93, 99) were not swept aside by the Supreme Court

in its opinion in *Lazarus*. The Supreme Court simply found that the Board of Tax Appeals (i) had properly recognized that the formal written documents may not be controlling and (ii) had correctly held that the facts in *Lazarus* justified application of the equitable doctrine that a deed intended as security will be treated as a mortgage.

The applicability of the same equitable doctrine was examined by the Board in its *City National* decision and because of the factual differences the Board concluded that the parties had not intended the transaction to be a mortgage and that the lessee was not the owner. What the Supreme Court was concerned with in the *Lazarus* case was whether the Board of Tax Appeals had applied the correct rule of law. It found that it had. The same rule of law was applied in the *City National* case, and if it had been that case in which the Supreme Court granted certiorari, it seems clear that its opinion would have been written in substantially the same way, affirming the result reached by the Board of Tax Appeals and the Court of Appeals for the District of Columbia.

That the *Lazarus* case did not overrule the decision in *City National* is established by the most recent land trust case, *The Akron Dry Goods Company,* 18 T.C. 1143 (1952), *aff'd per curiam,* 218 F.2d 290 (6th Cir. 1954). The Tax Court's discussion of the *Lazarus* case was as follows:

> "In the instant proceeding the formal details of the land trust certificate transaction pertaining to the fee simple deed to the Bank as trustee for the certificate holders and the leasing of the properties

> at a specified rental, etc., are essentially similar to those obtaining in the case of *F. & R. Lazarus & Co.,* 32 B.T.A. 633, affd. 101 F.2d 728, affd. 308 U.S. 252, wherein it was held that a deed absolute in form was, in equity, a mortgage to secure a loan where the parties so intended, and the taxpayer was allowed depreciation on the buildings on the property embraced in the deed. On authority of that case the petitioner contends for a similar holding here. However, in the *Lazarus* case the facts are that, aside from the deed indicating a sale, the other facts surrounding the transaction and particularly the testimony of the officers of the taxpayer and of the bank as to their intentions *at the time,* established a mortgage loan transaction and not a sale. In the instant case we have no such testimony." 18 T.C. 1143, 1146-1147.

The decision of the Tax Court was affirmed by the same Court of Appeals which affirmed the holdings of the Board of Tax Appeals in the *Lazarus* and *Neighbors* cases. 218 F.2d 290 (6th Cir. 1954). If *Lazarus* had overruled *City National,* as the District Court thought, then in the *Akron Dry Goods* case the Tax Court should have held as a matter of law that the transaction was a mortgage and the Court of Appeals should have reversed the Tax Court decision that the transaction involved a sale of the property.

V

The District Court has erroneously applied the double tax benefit theory of the Akron Dry Goods decision to the present case.

The statement of the District Court in its opinion that "the decision in *Akron* actually supports the position of defendant in this case" could only result from an

erroneous belief that a holding for appellant would result in a double tax benefit to it. This is not the fact.

In the *Akron Dry Goods* case the lessee in a land trust transaction in 1928 claimed and was allowed a loss on its tax return for its fiscal year 1929 on the theory that it had sold rather than mortgaged its building. In the intervening years before 1945, it claimed no depreciation on the building. In 1945 it asserted that the land trust arrangement was a mortgage transaction and claimed depreciation on the building despite the fact that it had already recovered its tax basis for the building through the loss deduction in 1929. The Tax Court first found that the 1928 transaction was a sale rather than a mortgage and then supported its holding by a comment which is quoted in the opinion of the District Court in the present case as follows (R. 32):

> "Furthermore, now to correct for the purpose of a claimed tax deduction benefit in the taxable year 1945 an alleged mistake, but actually an inconsistent position, which resulted in the petitioner's election to take tax deduction benefit in the taxable year 1929—a year as to which any adjustment is barred by the statute of limitations—would be contrary to the established principle of not allowing a double tax benefit."

The District Court followed this quotation with a statement that—

> "Clearly, the decision in the *Akron* case is in full accord with the government's position in this court" (R. 32).

What the District Court failed to understand was that if the taxpayer in *Akron Dry Goods* had been successful it would have used its basis for the building

twice for tax purposes—first to establish a deductible loss in 1929 and again to support depreciation deductions in 1945 and subsequent years. This would have violated the prohibition against double tax benefit.

A holding for appellant in the present case cannot result in a double tax benefit. It is true that Syndicate mistakenly deducted depreciation on the American Bank Building from 1927 to 1943. But New Company is not asking that this depreciation be restored to its basis for the building—even though much of the depreciation was deducted in loss years without tax benefit. On the contrary, New Company's contentions with respect to the issue involved in this appeal accept the fact that its investment in its leasehold estate must be reduced by depreciation claimed on tax returns by Syndicate and itself up to the date of exercise of the option in 1945. Indeed, the "Unamortized balance of leasehold estate per books as of December 31, 1944," shown in paragraph XII of the pretrial order (R. 9) is an amount computed after deduction of the full amount of depreciation erroneously claimed on prior tax returns. It is only this reduced amount that New Company contends should be retained as a part of its aggregate basis for the property after exercise of the option in 1945. Not only is there no possibility of double tax benefit to New Company but $274,784.49 of the depreciation deductions with which New Company is charging itself were claimed in loss years and will never result in any tax benefit.

Obviously in this situation it was error to apply to New Company the "double tax benefit rule" which was applied in the *Akron Dry Goods* case.

VI

The agreement determining the tax liability of Syndicate for 1927 has no effect for subsequent years.

In 1929 Syndicate executed an agreement pursuant to Section 606, Revenue Act of 1928 (agreement attached to revenue agent's report which is part of Exhibit 51-A), agreeing to the Internal Revenue Service's final determination of tax liability for the 1927 tax year. The District Court's reference to this as "a final closing agreement" (R. 28) seems to indicate that it believed that Syndicate had agreed to use the depreciation basis for the American Bank Building shown in the revenue agent's report for 1927, not only for purposes of the 1927 tax year, but for all future tax years in which a computation of depreciation on that property might be involved.

If this was the lower court's view, it was founded on a completely erroneous interpretation of the nature of the agreement entered into by the parties. That agreement related solely to the amount of Syndicate's tax liability for the 1927 tax year and was a final agreement only in the sense that neither Syndicate nor the Treasury Department could thereafter reopen the question of Syndicate's 1927 tax liability. The agreement did not purport to bind Syndicate or its successors to the use of any particular depreciation basis for future years.

There was no authorization in the 1928 Internal Revenue Code itself or in the Treasury Department's regulations which would permit a taxpayer and the government to enter into a closing agreement of any

kind as to tax questions which might arise concerning future years. Prospective closing agreements binding the parties as to questions concerning tax years not terminated prior to the date of agreement were not authorized until the enactment of the 1938 Act.

When the agreement was signed in 1929, the governing law was Section 606, Revenue Act of 1928, as to which the applicable regulations provided (Reg. 74, Art. 1301):

> "Closing agreements provided for in section 606 may relate to any taxable period *ending prior to the date of the agreement.*" (Italics added.)

The words "ending prior to the date of the agreement" in the statute and the first sentence of the regulations are the only provisions relating to the scope of closing agreements and clearly did not permit prospective agreements. Syndicate could not, therefore, have entered into any binding agreement with regard to use of a depreciation basis in the future and neither it nor the Treasury Department in executing the 1929 agreement purported to do so. There is then no basis for any inference such as the District Court has drawn that by reason of the 1929 agreement New Company is bound to use in future years the depreciation basis set forth in the revenue agent's report for the year 1927.

CONCLUSION

The rule of property law adopted in all of the land trust income tax cases is that a deed absolute on its face will be declared a mortgage only if both parties to the transaction so intended. The record in this case affirmatively shows that in the land trust transaction by which it acquired the Northwestern Bank property, Union intended that it should occupy the position of owner and that Syndicate should occupy the position of lessee and did not intend Syndicate to be the owner-mortgagor. The District Court nevertheless held that Syndicate was the owner of the building. In so holding it failed to apply the proper rule of law and its decision should be reversed.

Respectfully submitted,

THOMAS B. STOEL,
GEORGE H. FRASER,
DAVID G. HAYHURST,
Attorneys for Appellant,
1410 Yeon Building,
Portland 4, Oregon.

APPENDIX

Pages of Transcript of Record Showing Exhibits

Exhibit No.	Identified	Offered	Received
1	14	62	62
2	14	62	62
3	14	63	63
4	14	63	63
5	14	63	64
6	14	64	64
7	15	64	64
8	15	64	64
9	15	158	158
10	15	158	158
11	15	65	65
12	15	65	65
13	16	65	65
14	16	66	66
15	16	159	159
16	16	159	159
17	16	66	66
18	16	159	159
19	16	66	66
20	16	66	66
50-A	17	142	143
50-B	17	142	143
50-C	17	142	143
50-D	17	142	143
50-E	18	142	143
50-F	18	142	143
50-G	18	142	143
50-H-1	18	142	143
50-H-2	18	142	143
50-I	18	142	143
50-J	18	142	143
50-K	18	142	143
50-L	18	142	143
50-M	18	142	143
50-N	18	142	143

Exhibit No.	Identified	Offered	Received
50-O	18	142	143
50-P	18	142	143
50-Q	18	142	143
50-R	18	142	143
50-S	19	144	144
51-A	19	144	145
51-B	19	144	145
51-C	19	144	145
51-D	19	144	145
51-E	19	144	145
51-F	19	144	145
51-G	19	144	145
51-H	19	144	145
51-I	19	144	145
51-J	19	144	145
51-K	19	144	145
51-L	19	144	145
51-M	19	144	145
51-N	20	144	145
51-O	20	144	145
51-P	20	144	145
51-Q	20	144	145
51-R	20	144	145
51-S	20	144	145
51-T	20	144	145
51-U	20	144	145
51-V	20	144	145
51-W	20	144	145
51-X	20	144	145
51-Y	20	144	145
52-A	20	149	150
52-B	21	149	150
52-C	21	149	150
52-D	21	149	150
52-E	21	149	150
52-F	21	149	150
52-G	21	149	150
52-H	21	157	157
52-I	21	157	157

Exhibit No.	Identified	Offered	Received
52-J	21	157	157
52-K	21	157	157
52-L	21	157	157
52-M	21	157	157
52-N	21	157	157
52-O	21	157	157
52-P	21	157	157
54-A	22	146	147
54-B	22	146	147
54-C	22	146	147
54-D	22	146	147
54-E	22	146	147
54-F	22	146	147
54-G	22	146	147
54-H	22	146	147
54-I	22	146	147